

Office of Chief Counsel
Internal Revenue Service

memorandum

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TSMoraviaIsrael

date: JUL 03 2002.

to: [REDACTED], Revenue Agent (LMSB), Group [REDACTED] through [REDACTED]
[REDACTED], Team Manager

from: Associate Area Counsel (LMSB) Miami, Florida

subject: [REDACTED], Inc.
Deductibility of Monetary Sanctions under I.R.C. § 162(a)

This memorandum responds to your request for assistance.
This memorandum should not be cited as precedent.

This issue was coordinated with Diane Helfgoff, Industry
Counsel for Life Insurance.

ISSUE

Whether payments made by Taxpayer, which are characterized as "monetary sanctions" resulting from the multi-state examination of the Taxpayer's books and records, are fines or similar penalties for purposes of I.R.C. § 162(f) and therefore not deductible as business expenses under I.R.C. § 162(a).

FACTS

[REDACTED], Inc., (hereinafter referred to as "Taxpayer" or "[REDACTED]"), a domestic corporation, is a [REDACTED] company that, through its operating companies and affiliates, provides [REDACTED] and [REDACTED] in the United States and [REDACTED], as well as in [REDACTED] the [REDACTED], and the [REDACTED].

On [REDACTED], Information Document Request number [REDACTED] (hereinafter referred to as "IDR") was issued by the Revenue Agent requesting information regarding a general ledger entry for account number [REDACTED] entitled [REDACTED] and whether there were any entries regarding these amounts on Schedule M-1 of Taxpayer's U.S. Corporate Federal Income Tax Return for taxable year [REDACTED].

In response to the Revenue Agent's IDR, Taxpayer provided the following three items: Schedule M-1 of their U.S. Corporate Federal Income Tax Return for taxable year [REDACTED], which reflects a book expense not deducted on the return for \$ [REDACTED] labeled [REDACTED] a copy of a Consent Order and Compliance Plan, dated [REDACTED], entered into between [REDACTED] and the [REDACTED] states, and a one paragraph memorandum to the Revenue Agent, dated [REDACTED].

Beginning on [REDACTED], Taxpayer's books and records were examined by [REDACTED] to determine whether [REDACTED] was in compliance with the [REDACTED] regulations for [REDACTED]. On [REDACTED], a Consent Order and Compliance Plan was entered into between [REDACTED] and the [REDACTED]. Paragraph [REDACTED] of the Consent Order and Compliance Plan specifically states the following:

3. Monetary Sanction

[REDACTED]

In the memo dated [REDACTED], Taxpayer explains that the \$ [REDACTED] amount is reversed for tax purposes (as reflected on Schedule M-1) because it was not paid at year end. Taxpayer further states that the remaining amount (the \$ [REDACTED] monetary sanction less the \$ [REDACTED]) of \$ [REDACTED] was deducted, but that it was mislabeled as "[REDACTED] Penalties."

LAW AND ANALYSIS

I.R.C. § 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred by a taxpayer in carrying on a trade or business. Amounts expended by a taxpayer engaged in a trade or business to avoid or settle litigation may be deductible as an ordinary business expense. See, e.g., Ditmars v. Commissioner, 302 F.2d 481, 485 (2d Cir. 1962); Old Town Corp. v. Commissioner, 37 T.C. 845 (1962), acq., 1962-2 C.B. 5.

I.R.C. § 162(f), however, prohibits a deduction under I.R.C. § 162(a) for any fine or similar penalty paid to a government for the violation of any law. Treas. Reg. § 1.162-21(b)(1) defines a "fine or similar penalty" to include any amount (i) Paid pursuant to conviction or a plea of nolo contendere for a crime in a criminal proceeding; (ii) Paid as a civil penalty imposed by federal, state, or local law; (iii) Paid in settlement of the

taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or (iv) Forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty. Treas. Reg. § 1.162-21(b)(2) provides that compensatory damages paid to a government do not constitute a fine or penalty.

I.R.C. § 162(f) disallows a deduction for civil penalties that are imposed for the purpose of enforcing the law or as punishment for violation of the law. However, a civil payment, even if it is labeled a penalty, may be deductible if it is imposed to encourage prompt compliance with a requirement of the law or as a remedial measure to compensate another party. Waldman v. Commissioner, 88 T.C. 1384, 1387 (1987), aff'd, 850 F.2d 611 (9th Cir. 1988); Huff v. Commissioner, 80 T.C. 804, 821-22 (1983); S. Pac. Transp. Co., 75 T.C. 497, 646-54 (1980); Allied-Signal, Inc. v. Commissioner, T.C. Memo 1992-204, aff'd, 54 F.3d 767 (3d Cir. 1995). Where a payment could serve both punitive and compensatory purposes, it is necessary to determine which purpose the payment was designed to serve. S&B Restaurant, Inc. v. Commissioner, 73 T.C. 1226, 1232 (1980); Middle Atl. Distribs. v. Commissioner, 72 T.C. 1136, 1145 (1979); Grossman & Sons, Inc. v. Commissioner, 48 T.C. 15, 31 (1967).

The characterization of a payment for purposes of I.R.C. § 162(f) depends on the origin of the liability giving rise to the payment. Bailey v. Commissioner, 756 F.2d 44, 47 (6th Cir. 1985); Middle Atl. Distribs., 72 T.C. at 1144-45; Uhlenbrock v. Commissioner, 67 T.C. 818, 823 (1977). The origin of a settlement payment would generally be the original claim to which the payment relates. See Adolf Meller Co. v. United States, 600 F.2d 1360, 1363-64 (Cl. Ct. 1979). However, courts will typically give effect to the express characterization of a settlement payment by the parties to a settlement agreement. See Middle Atl. Distribs., 72 T.C. at 1145; Grossman & Sons, Inc., 48 T.C. at 29; Rev. Rul. 80-334, 1980-2 C.B. 61.

In ascertaining whether a payment is punitive or compensatory, courts analyze the purpose of the statute imposing the penalty (or forming the basis of claims that are settled). Both the language of the statute and its legislative history are relevant to this inquiry. If the law is designed to compensate the injured party for its damages, then I.R.C. § 162(f) is likely to be inapplicable. See, e.g., Mason and Dixon Lines, Inc. v. United States, 708 F.2d 1043, 1047 (6th Cir. 1983) (holding that liquidated damages for violating state truck weight limits were compensatory based on the structure and language of the relevant provision). If the law is designed to be punitive or to deter the type of conduct committed by the taxpayer, then

the payment is likely covered by I.R.C. § 162(f). See, e.g., True v. United States, 894 F.2d 1197, 1205 (10th Cir. 1990) (holding that amounts paid for violating the Federal Water Pollution Control Act were penalties because "on balance" the civil penalty provision served "a deterrent and retributive function similar to a criminal fine"); Colt Indus., Inc. v. United States, 11 Cl. Ct. 140, 146-47 (1986) (holding that civil penalties under the Clean Air Act and the Clean Water Act had a punitive purpose and were nondeductible), aff'd, 880 F.2d 1311 (Fed. Cir. 1989); Huff, 80 T.C. at 824 (concluding that a civil penalty had a punitive purpose based on a state supreme court decision holding that the statute imposing the penalty was designed to penalize defendants).

If it cannot be determined whether a statute imposing a penalty serves compensatory or punitive purposes, or if the statute serves both purposes, it is necessary to consider the specific facts surrounding the payment at issue, including a comparison of the payment amount with the actual damages caused by the conduct at issue. If a payment exceeds the amount needed to compensate the victim, or if it is in addition to a separate compensatory payment, it can often be inferred that the payment had a punitive purpose. See, e.g., Adolf Meller Co., 600 F.2d at 1361-62 (holding that a \$43,000 payment in settlement of a customs penalty was punitive where it was in addition to lost customs duties paid).

The Consent Order and Compliance Plan, dated [REDACTED], entered into between [REDACTED] and the [REDACTED], ordering the payment of a monetary sanction by [REDACTED] states that although "... [REDACTED] denies participation ..." in the violation of [REDACTED] "...

[REDACTED]

[REDACTED]

Of the \$ [REDACTED] sanction assessed against [REDACTED] by the [REDACTED], \$ [REDACTED] is to be paid immediately to the [REDACTED] and the remaining \$ [REDACTED] is to be paid at a later date should the result of a re-examination of [REDACTED] by the [REDACTED], on or after [REDACTED] result in a finding of [REDACTED]'s noncompliance.

It is clear from the language cited to above that the monetary sanction in the amount of \$ [REDACTED] is designed to be punitive and to deter the type of conduct committed by the Taxpayer and is therefore covered by I.R.C. § 162(f). If the

Taxpayer deducts the remaining \$ [REDACTED] in a later year as a result of a re-examination of [REDACTED] by the [REDACTED], please contact this Office, as we have authority for disallowing said deduction. See S. Pac. Transp. Co., 75 T.C. 497, 652 (1980).

CONCLUSION

Based on the above discussion, it is the position of this office that of the original monetary sanction of \$ [REDACTED] \$ [REDACTED] is punitive, and therefore covered by I.R.C. § 162(f).

This advisory opinion has been reviewed by the National Office. If you have any questions regarding the foregoing, please contact Tamara Moravia-Israel at (305)982-5319 or Andrew M. Tiktin at (305)982-5321.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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